This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 05 ABUJA 001419

SIPDIS

STATE ALSO FOR USAID

E.O. 12958: N/A
TAGS: ECON EAID ENRG EFIN NI
SUBJECT: Nigeria's Macroeconomic Picture -
Where We Stand At Year Two of Democracy

Refs: (A) Abuja 1375, (B) Abuja 1374 (C) Abuja 1365
(D) Abuja 792, (E) Abuja 742, (F) Abuja 129,
(G) Abuja 127, (H) Abuja 30, (I) Abuja 004

Summary

¶1. Economic policy and performance in 2000 and so far in 2001 have been mixed. Growth may have been sufficient to produce a small "democracy dividend" and privatization is moving ahead. The GON remains committed to fuel deregulation. Nevertheless, the 2000 and even more the 2001 budgets have created problems. No Stand-by Arrangement with the IMF has been reached; inflation is up and interest rates are rising; the Naira is under pressure. Over-dimensioned and prestige projects and investments in state-owned enterprises raise questions about the GON's commitment to creating a private sector-led economy. Dialogue with the GON on the budget is imperative, not only to support IMF efforts to rein in excessive spending, but also to encourage the GON to devote more funds to poverty alleviation and growth. The threatened re-introduction of fertilizer subsidies is a serious issue in agricultural policy. Attempting to offset these tendencies, the Mission is engaged in policy advocacy across the board, including emphasis on policy coordination, budget process reform, domestic debt and interest rate issues, as well as privatization. The U.S. must take a long-view and work with Nigerians who share our vision of reform; our expectations of instant results may have to be dampened. Nevertheless, we should seek solid results in the short-run, build capacity for the longer-term and help our counterparts to develop an enabling environment that fosters transparent, responsible and democratic government. End Summary.

The Political Economy

¶2. Nigeria is beginning a third year of a very difficult transition after 30 years of military misrule. The new government faces an array of issues that must be overcome if Nigeria is to make a successful transition to a democratic market economy:

-- Pervasive poverty, unemployment and an attendant lack of personal security coupled with the political imperative to provide tangible results in order to give democracy and the present government legitimacy.

-- Weak institutional capacity at all levels of government to execute coherent policies.

-- Widespread corruption and an almost stagnant non-oil economy.

-- A pervasive mindset that looks to government for solutions to every problem.

¶3. Economic policy and performance in 2000 and, thus far, in 2001 have been mixed. Reforms have not yet gone far enough to stimulate significant growth in production or new investment. Expansion in the economy in 2000 seems to have been between 2.8 and 3.8 percent (depending on statistical source), but not clearly greater than the average of 2.9 percent since 1993, which was barely sufficient to keep up with population growth. Even the top end of the growth

range would allow for only a very small emocracy dividend - a significant increase in the average Nigerian's standard of living expected as a result of democratization -- and definitely less than the 5.9 percent per annum achieved during 1987-93, the last period of economic reform. Moreover, it is unlikely there ever will be a large "dividend" so long as so much of the economy, especially energy production and distribution, remain in State hands and insufficient budgetary resources are devoted to poverty alleviation and growth.

Economic Setting -- Positive Elements:
Privatization, Deregulation, IMF Targets

¶4. The ongoing process of selling off parastatals: (a) fourteen state-owned (or partially owned) enterprises in the banking, cement, and fuel retailing sectors have been sold; (b) the Government has announced that consultants to start Phase II privatization of Nigerian Airlines, vehicle assembly plants, palm oil companies and fertilizer plants have been selected; (c) the transparent and financially successful January auction of GSM licenses for mobile telephones was especially encouraging, both for the prospect of rapid improvements in mobile telephone service as well as a harbinger of the privatization of NITEL itself, optimistically scheduled for September
¶2001. (Note: In a surprise move June 12, President Obasanjo abruptly dismissed Minister of Communications Mohammed Arzika, Minister of State for Power and Steel Danjuma Goje, and Special Advisor for Economic Affairs Philip Asiodu (Ref C). Press reports have described these advisors as dragging their feet on privatization. The removal of Asiodu, in particular, leaves Vice President Atiku Abubakar a free rein to exercise his broad supervisory authority over privatization and deregulation. End Note.)

¶5. The attempt to liberalize fuel prices, even though mishandled, and now delayed, shows recognition of the non-sustainability of the current subsidy structure costing in the neighborhood of 2.6 billion USD annually (Ref E). The Government continues to prepare public opinion for an eventual deregulation of fuel prices. We are reassured in private, and leading GON officials, e.g., Minister for Finance Ciroma, have said publicly that deregulation is a done deal, that it's not a question of whether but rather when.

¶6. For the first time in over a decade, Nigeria agreed to set macroeconomic targets under a 2000 Stand-by Arrangement (SBA) with the International Monetary Fund, although it was not expected that any funds would be drawn under the arrangement. As part of this agreement, a mechanism was created to stabilize government income by stashing away part of the oil revenues for a "rainy day." The Standby paved the way for an agreement in principle with the Paris Club to reschedule Nigeria's debt. Otherwise, the SBA process has been arduous and less than successful thus far.

¶7. The GON remains in conversation with the IMF about the reestablishment of targets for a new SBA and quick decisive action could still pull the economy from the brink of macroeconomic instability. In an attempt to address the budget issue, the government has agreed with the IMF to undertake a "due process" review of the capital budget, where most of the problem lies. Ostensibly, this review is merely to ensure that correct procedures have and will be followed in the contracting of works valued at over 250 million Naira. This process is also the GON's attempt to address transparency and corruption issues. It is hoped that due process review could prevent improper disbursement of as much as 2 billion USD from the 2001 capital budget.

-- -
Economic Setting -- Problem Areas:
Fiscal Policy, Inflation, Exchange Rates, Debt
-- -

¶8. Implementation of the 2000 budget was problematic and the 2001 budget is far in excess of what can be prudently financed. President Obasanjo had the

misfortune to come into office at a time of high oil prices, which created unrealistic expectations and temptations to spend on over-dimensioned and prestige projects. After low spending in the first half of 2000 because of the stalemate between the President and the National Assembly, spending began in earnest in the second semester. Expenditures quickly exceeded the agreed-to targets for the deficit, international reserves, and other indicators of the SBA.

¶9. Disturbing signs continue in 2001. The government missed virtually all its targets under the 2000 Standby and has not signed a new SBA with the IMF because of disagreements over the 2001 budget, both for its expansionary aggregate numbers and the structure of expenditures.

¶10. The FY 2001 budget, as passed, calls for 910 billion Naira (7.0 billion USD) in total spending for the federal government, a 40 percent increase over the year before. Some sources forecast a 200 billion Naira (1.53 billion USD) deficit for FY 2001, up from a 137 billion Naira deficit (1.05 billion USD) in FY ¶2000. This is largely a result of the capital expenditures, which are almost three times as great as the amount agreed for FY 2000 under the SBA and about 80 greater than budgeted in the year before. To further complicate matters, on top of the ordinary budget, under pressure from the States, the Federal Government has agreed to distribute about 60 percent of the "rainy day" fund to the States and Local Governments this year, about 900 million USD. Moreover, plans seem to be afoot for a "supplementary" budget that would further exacerbate the macro-economic picture. Nevertheless, GON senior advisors maintained June 12 that the approximately 100 million USD "supplementary budget" would have "absolutely zero" net effect on capital spending for the year (Ref A). Notwithstanding that assurance, full execution of the 2001 budget, with the additional pressure from a supplementary budget, could threaten a macro-economic meltdown.

¶11. A review of the 2001 budget reveals unnecessary spending on wasteful or over-dimensioned capital projects like the national stadium, a huge water supply project for Abuja, and investments in moribund state-owned enterprises like the Ajeokuta steel mill (Refs F&I). A high proportion of the capital budget goes to building Abuja, the new seat of government, and the construction of government buildings in other parts of the country.

¶12. The government has announced re-introduction of fertilizer subsidies even though these have never reached the poor and are a fount of corruption (Refs G&H).

¶13. Signs of impending instability from budget mismanagement abound. During April, for example, the Central Bank, in order to mop up the excess liquidity from large capital projects, was forced to raise the Minimum Discount Rate from 15.5 to 16.5 percent, the Cash Reserve Requirement from 11 to 12.5 percent and the Minimum Liquidity Ratio from 35 to 40 percent. At the time, CBN officials said the moves were very temporary. In a conversation with EconChief June 15, however, CBN senior staff said the new rates could remain in effect indefinitely and there would be further hikes if the National Assembly were to show further "irresponsibility." In response to the CBN actions, the inter-bank lending rates peaked in recent weeks at 50 percent, but have dropped back to the 25-35 percent range, still up from the February maximum lending rate of 26 percent.

¶14. Inflation, which by the end of 1999 was virtually zero, 2-4 percent, by April had climbed back to over 23 percent per annum. It seems to have moderated somewhat since then but still remains excessive, particularly for food which accounts for two-thirds of the "basket of good and services" the CBN uses in computing the Consumer Price Index. That measure of price increase, according the Central Bank, is fully 17 percent higher today than it was at this time last year.

¶15. IMF and World Bank economists tell us that for large GON capital undertakings, 65 to 85 percent of

the money actually spent on projects goes to foreign inputs. The total effect of purchasing these inputs (denominated in U.S. dollars) and of exchanging Naira skimmed from contracts has been to exert extreme downward pressure on the value of the Naira, which the CBN must defend in foreign exchange markets. Thus far in 2001, the Inter-Bank Foreign Exchange Market (IFEM) rate has gyrated dramatically from near 100 Naira to the dollar to almost 130 Naira per dollar. A disturbing and variable gap between the IFEM and parallel market has developed, increasing the incentives for corruption through "round-tripping," a procedure by which funds obtained from the Central Bank at preferential rates are then sold at a mark up in the parallel market.

¶16. Apart from the issues of deficit, soaring inflation, and the plunging value of the Naira -- and the political problems these will entail -- one cannot but wonder if the FY 2001 budget represents a return to the mentality of the 70s and 80s in which government, not the private sector, was seen to be the engine of economic growth. As in previous years, the budget systematically UNDER funds: primary health care; education; farm-to-market road construction and maintenance; collection, analysis, and publication of data; the judiciary; and funding of the elections and anti-corruption commissions.

¶17. At the end of 2000 Nigeria's external public medium- and long-term debt was estimated at 32.2 billion USD consisting of 28.4 billion USD to bilateral and multilateral donors (less than 1 billion to the U.S.) and 3.8 billion USD to commercial creditors. Debt service due in 2000 was 14.5 percent of exports, not high for Africa, but actual payments reached only 8.1 percent of exports. Nigeria reached an agreement in 2000 with the Paris Club to reschedule 22.7 billion USD. Payments due under the agreement were 700 million in 2000, not fully paid, and 1.0 billion USD in 2001. The Paris Club rescheduling also is complicated by a stall in the bilateral negotiations between Nigeria and 10 of it creditors. Debt Management Office officials told EconChief June 12 that the GON would request a three-month extension on the Paris Club bilaterals so that the U.S. and nine other creditor nations might "develop reasonable positions" on debt relief (Ref A). Further, Nigeria's argument that its development is strongly inhibited by debt is undermined both by the current price of oil and its record so far of failing to direct it's OWN resources to poverty-reducing and developmental ends.

The Way Ahead & USG Assistance

¶18. Should the overall picture discourage us? No, there are positive signs and a commitment in many quarters to substantive reform. The government has reiterated is decision to deregulate fuel prices, for instance, the first step in being able to privatize fuel production, refining and distribution. Privatization is moving into Phase II and has a strong champion in President Obasanjo, Vice President Abubakar and other leading government officials; the BPE has a dynamic leader in Nasir el-Rufai.

¶19. In macro-economic policy, we have seen CBN, with the blessing of the Ministry of Finance, go to the market with a new instrument, the CBN Certificate issued in 180- and 360-day terms and bearing a better rate than the traditional T-Bills. CBN Director of Research Joseph Nnanna up-dated EconChief on the certificates program June 18. Originally, the CBN had planned on sterilizing 100 Billion Naira via the certificate program. Eighty billion of that goal was reached through four public offerings by mid-term of the second quarter. Seventy-five percent of the certificates sold pay 19 percent per annum on a 180-day term; the balance pay 21.5 on a 360-day term. Additionally, and due to three rediscount rate hikes this year, the CBN had, as of June 15, sterilized an additional 51 billion Naira via the sale of 90-day T-Bills at 17 percent per annum. Although these movements may not be enough in the short-run, they do represent a change in interest rate policy that is necessary for macroeconomic management in the future. The CBN clearly is prepared to take the heat for its increased prudence in managing macro-economic policy development.

¶20. The U.S. is actively engaged in seeking to influence the course of Nigerian policy-making procedures and economic performance. Early in the Obasanjo Administration, the US responded to an IMF request for placement of a long-term advisor in the nascent Economic Policy Coordinating Committee (EPCC) in the Vice President's office. The EPCC is a kind of economic cabinet, covering a wide range of macro-economic and poverty reduction issues. The U.S. advisor has been well received and put in charge of chairing fortnightly meetings of the Technical Committee, which he initiated. This will be the first time economic policies are discussed in an open forum with all key Ministers present. The EPCC also will host public fora for discussions of inflation and unpopular reforms such as petroleum price deregulation. Our Embassy is also developing programs to engage labor leaders and others as constructive interlocutors in the national economic policy dialog.

¶21. The U.S. has also secured GON agreement to placing two Treasury employees at critical interstices of the GON's financial structure. One, at the Ministry of Finance, will provide assistance to the resurrected Budget Office in developing a rational budget process for the GON. This is critical support for a government without a formal budget process, where individual Ministries hold private bank accounts, and no one knows the actual number of Federal Government employees. The possibility of further support is under consideration. The second Treasury employee, assigned to the recently re-structured Debt Management Office, will provide domestic debt management expertise, complementing a World Bank officer already working the external debt account. The assistance of our advisor should prove critical in Nigeria's effort to create a stable demand for Federal debt instruments of extended maturity and at reduced interest rates.

¶22. The U.S. also has provided the Bureau of Privatization (BPE) with a team of advisors specializing in areas essential to a rational privatization process, among them, valuation procedures, transaction dynamics, labor retrenchment issues and public awareness. The U.S. is the leading external supporter of the BPE. Other donors see USG assistance as a precondition for their own involvement.

Comment

¶23. Even if the Nigerian economy is in for a rough ride in the short and medium term -- higher inflation and a soaring exchange rate upporters of Nigeria economic transformation
need to keep in view a longer-
term perspective, and perhaps even ratchet down expectations of the possible in the short-run. Democracy is a learning process and suffering the consequences of mistakes can itself be a learning experience. We need to work with people -- and there are a lot of them -- who share our vision of reform. We should seek solid results that make a difference in the short-run, that build capacity for the longer-term, and that help our counterparts to fulfill effectively their charge to ensure an enabling environment that fosters transparent, responsible and democratic government. Our efforts must continue.
JETER